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## The Cost of Contract Renegotiation: Evidence from the Local Public Sector<sup>1</sup>

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### Abstract:

We construct and estimate a structural principal/agent model of contract renegotiation in the French urban transport sector in a context where operators are privately informed on their innate costs (adverse selection) and can exert cost-reducing managerial effort (moral hazard). This model captures two important features of the industry. First, only two types of contracts are used in practice by local public authorities to regulate the service: cost-plus and fixed-price contracts with positive subsidies. Second, these subsidies increase over time. Such increasing subsidies are consistent with the theoretical hypothesis that principals cannot commit not to renegotiate and contracts are renegotiation-proof. We compare this situation to the hypothetical case with full commitment. The distribution of innate costs of operators is shifted upwards under this hypothetical scenario. The welfare gains of commitment are significant and accrue mostly to operators. Estimates of the weights that local governments give to the operator's profit in their objective functions and of the social value of the cost-reducing managerial effort are obtained as by-products.

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# 1 Introduction

Real world contractual relationships are ongoing processes in changing environments. Parties lay down arrangements for trading goods and services covering several periods. However they often recontract as new information on market demand and costs structure becomes available. Although economic theory has devoted considerable attention to understanding dynamic contractual relationships and especially how contracts may be renegotiated over time, the empirical literature on those issues lags much behind both in terms of volume and scope. This gap is a real concern both for theorists who may need empirical evidence to target their effort towards sensible issues but also for applied economists who might be *de facto* missing the theoretical models that could be amenable to empirical analysis.

The main lessons of the theoretical literature is that renegotiation matters for contract design. Renegotiation has a positive impact because it improves contracting *ex post*. However, once those efficiency gains are anticipated, renegotiation has also perverse effects on contractual parties' *ex ante* incentives: information may be incorporated in contract design only at a slow pace;<sup>1</sup> the threat of regulatory hold-up may impede specific investments which requires costly governance and safeguards arrangements;<sup>2</sup> and finally optimal risk-sharing arrangements may be disrupted.<sup>3</sup> Overall, renegotiation imposes transaction costs on *ex ante* contracting. Those costs prevent from achieving the informationally constrained efficient solution that could have been reached if the parties had bind themselves to a long-term contract. An open issue from an empirical viewpoint is to assess the welfare losses associated with a limited commitment. Beyond, another important question is also to understand how those losses are distributed between contracting parties.

Answering those questions is crucial both for researchers to ascertain the relevance of a whole body of theoretical literature on renegotiation, but also for practitioners who may want to evaluate the performances of real-world contractual practices. In this respect, the French urban transportation sector offers a particularly attractive field for study. Motivated by a concern towards improving *ex ante* competition among potential operators, the

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<sup>1</sup>See the seminal paper by Dewatripont (1989) and the literature on adverse-selection under imperfect commitment (Hart and Tirole, 1988, Laffont and Tirole, 1993, Chapter 10, among others). Laffont and Martimort (2002, Chapter 9) provide some entries.

<sup>2</sup>Williamson (1985).

<sup>3</sup>Fudenberg and Tirole (1990).

1993 Law on Transportation imposed that franchise contracts must be re-auctioned and “re-negotiated” every 5 years by public authorities in charge of regulating the service. Since then, practitioners in the industry have repeatedly complained that this institutional constraint on contract length is too tight. Expectations that welfare gains could be achieved by increasing contract duration is at the source of an ongoing political debate and some political activism by operators.

*Motivation.* This paper has two main objectives. First, we construct and estimate a structural principal/agent model of contract renegotiation in the French urban transport sector. A basic assumption of this model is that contracting takes place under asymmetric information: operators are privately informed on their innate costs at the time of contracting with public authorities. Second, we use those estimates to recover not only the welfare gains but also their distribution if full commitment were feasible. These gains are significant although unevenly distributed: operators are net winners when the length of the contract is extended whereas taxpayers/consumers lose.

Our model accounts for two important features of the industry. First, only two kinds of contracts are used in practice by local public authorities (principals) to regulate the service: cost-plus and fixed-price contracts. It is well-known from the works of Laffont and Tirole (1993, Chapter 1), Rogerson (1987), Melumad, Mookherjee and Reichelstein (1992) and Mookherjee and Reichelstein (2001) that such menus of linear contracts have strong incentive properties under asymmetric information. Menus facilitate self-selection of operators according to their private information on innate costs. In addition, linear contracts have also nice robustness properties under cost uncertainty.<sup>4</sup> More importantly, from an implementation viewpoint, menus approximate quite well, and are even sometimes able to achieve what more complex nonlinear contracts would do.<sup>5</sup> Rogerson (2003) argued that, in most real-world procurement contexts, a simple two-item menu (cost-plus/fixed-price) may suffice to achieve much of the gains from trade, even under asymmetric information.<sup>6</sup>

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<sup>4</sup>Laffont and Tirole (1993, Chapter 1, p.109) and Caillaud, Guesnerie and Rey (1992).

<sup>5</sup>Laffont and Tirole (1993, Chapter 1) showed that the optimal nonlinear cost reimbursement rule can be implemented with a menu of linear contracts when this rule is convex. Wilson (1993) and McAfee (2002) demonstrated that such menus might only contains a few items.

<sup>6</sup>More specifically, Rogerson (2003) supposed that the firm’s innate cost which is its private information is uniformly distributed and shows that this simple menu can secure three fourth of the surplus that an optimal contract would achieve. Chu and Sappington (2007) challenged this result beyond the case of a uniform distribution. On a related note, Bower (1993), Gasmi, Laffont and Sharkey (1999), Schmalensee (1989) and Reichelstein (1992) investigated the value of relying on a single linear contract and concluded also on the good welfare performances achieved with such rough contract design.

A second important feature of the urban transportation sector is that subsidies (or “*compensations*” as they are often called by practitioners) paid to operators increase over time no matter the characteristics of the service. Our theoretical model provides a rationale for such patterns as resulting from the limited ability of local authorities to commit and the fact that, as time goes on, the operator’s cost structure gets better known. This argument is already familiar from the agency literature on limited commitment.<sup>7</sup> We revisit this insight in an institutional context where two-item menus are the only feasible incentive mechanisms. Whereas the existing theoretical literature on limited commitment has focused on discrete types models, derived fully optimal renegotiation-proof contracts but is often criticized for its lack of tractability, our model below imports much of the tractability of Rogerson’s model into a framework where contracts are renegotiated over time.<sup>8</sup> In doing so, we look for a theoretical modeling that is consistent with our data set. In particular, considering a continuum of types is a prerequisite to evaluate a meaningful distribution of cost parameters in our empirical model. This allows us to neatly characterize the probabilities of various contractual regimes (cost-plus, fixed-price, and changes over time between those two options). This is an important preliminary step of our estimation procedure based on a maximum likelihood criterion.

*Empirical analysis.* Turning more specifically to the empirical part of our study, we consider the two scenarios of full and limited commitment with renegotiation and estimate structural parameters of the model under each hypothesis. To understand the estimation bias that arises when wrongly assuming full commitment, it is useful to come back on the basic intuition behind the trade-off between *ex post* efficiency and *ex ante* incentives that appears under renegotiation. Roughly speaking, since renegotiation raises subsidies in later periods of contracting, even less efficient operators may choose fixed-price contracts at the renegotiation stage. Even though this also yields efficiency gains, renegotiation increases informational rents for the most efficient operators which makes them less eager to reveal their types earlier. From the public authorities’ viewpoint, renegotiation is found more attractive *ex post* when the operator’s information rent has a lower weight in the public authorities’ objective functions and when the social value of managerial effort is greater so that the efficiency gains from renegotiation dominate its costs in terms of

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<sup>7</sup>Dewatripont (1989), Laffont and Tirole (1993, Chapter 10), and Laffont and Martimort (2002, Chapter 9) among others.

<sup>8</sup>Rogerson’s analysis is static and cannot by definition describe the rich dynamic patterns observed in our data set, in particular the steady increase in subsidies over time and the move towards fixed-price contracts as time goes on.

extra information rents left to operators. Neglecting the possibility of renegotiation and wrongly assuming that a full commitment regime prevails amounts thus to underestimate the social value of managerial effort, giving to the operators' information rent a greater weight in the public authorities' objective functions and, finally, introducing biases in the estimation of the distribution of innate costs that tend to overestimate information rents. Estimating this distribution for the set of operators in our data set under either a full commitment or a renegotiation scenario, we find that operators are slightly more efficient before undertaking any cost-reducing activities when assuming renegotiation. Finally, a last result of our estimation is that operators provide on average less managerial effort in that scenario.

From our empirical analysis, we estimate also the weight of the operator's profit in the public authority's objective function. This weight depends on the political color of the public authority. In particular, right-wing principals are more prone to give up information rents to operators.

Finally, using our estimates of the operator's innate cost distributions and other parameters of the model, we evaluate the welfare gains that would be obtained when moving to the full commitment solution. The intertemporal subsidies under full commitment are higher than under renegotiation, so that taxpayers are the net losers from a hypothetical increase in the duration of contracts. However, the overall welfare gains are significant. Taxpayers bear an increase in tax burden of 3.8 per cent whereas operators see their expected information rent increase by roughly 12.2 per cent. This result clearly explains the operators' political activism in pushing for reforms that would increase contracts length.

*Literature review.* Our model borrows on the recent empirical literature on contracts and regulation. First, as already explained, we contribute to the ongoing empirical debate on whether complex menus of contracts are actually implemented in practice, or, on the contrary, regulators use menus with a reduced number of items. In a pioneering paper, Wolak (1994) estimated the production function of a Californian water utility, and argues that regulatory mechanisms *à la* Baron and Myerson (1982) are used. Assuming instead cost observability as in Laffont and Tirole (1993), Gasmi, Laffont and Sharkey (1997), Brocas, Chan and Perrigne (2006) and Perrigne and Vuong (2007) considered complex regulatory schemes to estimate costs and demand parameters of structural regulatory models. Other empirical studies argue instead that principals do not use such complex

mechanisms. Bajari and Tadelis (2001) focused on the private construction industry in the U.S. and argue that most contracts are either cost-plus or fixed-price. The reason for such restricted menu is that public authorities look for an appropriate trade-off between providing *ex ante* incentives with fixed-price contracts and avoiding *ex post* transaction costs due to costly renegotiation with cost-plus arrangements. Considering contracts in the automobile insurance industry, Chiappori and Salanié (2000) restricted the analysis to simple menus with two types of coverage. In the field of transportation, Gagnepain and Ivaldi (2002) focused on the incentive effects of cost-plus and fixed-price contracts. They measured actual welfare related to real regulatory practices, and compared this measure to what could be achieved if more complex second-best mechanisms were implemented. The present paper improves significantly upon Gagnepain and Ivaldi (2002) by explicitly modeling contract design by public authorities and giving more attention to the dynamic choice of contracts by operators.

A second feature of our empirical model is related to the dynamic nature of the contractual relationship between the principal and the agent. Dionne and Doherty (1994) focused on the car insurance industry in California and suggested that insurers may use long-term contracts as a device to enhance efficiency and attract portfolios of dominantly low-risk drivers. We illustrate here how long-term contracts may benefit both to public authorities and transport operators.

Finally, our analysis assumes that local public authorities may be tempted to favor private interests when designing contracts. The political color of the local government influences the distribution of welfare among the different actors involved in their provision. Empirical tests on capture and ideology in politics are given in Kalt and Zupan (1984, 1990). Those papers provided evidence on the fact that policymakers' ideology may have a significant impact on regulatory outcome, in a way that is similar to what happens in the French transportation sector.

Section 2 gives an overview of the French urban transportation industry. Section 3 presents our theoretical model and solves for the optimal menu of contracts (fixed-prices/cost-plus) both under full commitment and renegotiation. We derive in particular the important property that subsidies increase over time under a renegotiation-proof scenario. Section 4 develops our empirical method. Section 5 evaluates the magnitude of the welfare gains when moving to full commitment but also the distribution of those gains

between operators and taxpayers. Section 6 concludes by highlighting a few alleys for further research. Proofs of the theoretical model are developed in an Appendix.

## **2 The French Urban Transportation Industry**

As in most countries around the world, urban transportation in France is a regulated activity. Local transportation networks cover each urban area of significant size. For each network, a local authority (a city, a group of cities or a district) contracts with a single operator to provide the service. Regulatory rules prevent the presence of several suppliers of transportation services on the same urban network. A distinguishing feature of France compared to most other OECD countries is that about eighty percent of local operators are private and are owned by three large companies, two of them being private while the third one is semi-public.<sup>9</sup> These companies, with their respective type of ownership and market share (in terms of number of networks operated) are in 2002: KEOLIS (private, 30%), TRANSDEV (semi-public, 19%), CONNEX (private, 25%). In addition there are a small private group, AGIR, and a few public firms under local government control.

### **2.1 Economic Environment**

The 1982 French Law was enacted to facilitate decentralized decision-making on urban transportation and to provide a guide for regulation. As a result, each local authority organizes now its own transportation system by setting the route structure, the capacity level, the quality of service, the fare structure, the conditions for subsidizing the service, the level of investment and the nature of ownership. The local authority may operate the network directly or it may delegate that task to an operator. In this case, a formal contract defines the regulatory rules that the operator must follow as well as the cost-reimbursement rule between the public authority and the operator.

Since 1993, beauty contests are required to allocate the building and management of new infrastructures for urban transportation when the renewal of contracts comes to an end. In practice, however, very few networks change operators from one regulatory period to the other. Documentary investigation sheds light on the fact that awarding

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<sup>9</sup>For an overview of the regulation of urban transit systems in the different countries of the European Union, in the United States and Japan, see IDEI (1999).

transport operations through tenders does not necessarily guarantee ex ante competition since local transport authorities usually receive bids from one single candidate, namely the operator already in place. Several reasons potentially explain this phenomenon. First, local authorities are either reluctant to really implement the law or do not have enough expertise to launch complex calls for tenders. Second, the three groups owning most of the urban transport operators in France are usually located on specific geographical areas. This restricts competition in awarding transport operations in urban areas where regulatory contracts come to an end. These groups also operate other municipal services such as water distribution or garbage collection, which makes it even harder for the regulator to credibly punish the operator in case of bad performance.

In most urban areas, operating costs are twice as high as commercial revenues on average. Budgets are rarely balanced without subsidies. One reason is that operators face universal service obligations and may have to operate in low demand areas. Prices are maintained at a low level in order to ensure affordable access to all consumers of public transportation. Moreover, special fares are provided to targeted groups like pensioners and students. Subsidies are taken from the State's budget, the local authority's budget, and a special tax paid by any local firm (employing more than nine full-time workers). In addition to the price distortions causing deficits, informational asymmetries that affect the cost side make it more difficult to resume these deficits. This aspect is discussed in more details in the sequel.

Performing a welfare analysis of regulatory schemes requires a database that encompasses both the performance and the organization of the French urban transport industry. The basic idea is to consider each system in an urban area during a time period as a realization of a regulatory contract. Such a database has been created in the early 1980s. It results from an annual survey conducted by the *Centre d'Etude et de Recherche du Transport Urbain* (CERTU, Lyon) with the support of the *Groupe des Autorités Responsables du Transport* (GART, Paris), a nationwide trade organization that gathers most of the local authorities in charge of a urban transport network. This rich source is probably unique in France as a tool of comparing regulatory systems both across space and over time. For our study, we have selected all urban areas of more than 100,000 inhabitants for homogeneity purposes. Indeed, smaller cities may entail service and network characteristics that differ significantly from those in bigger urban areas. Discarding these smaller cities allows us to identify in a more satisfactory manner differences in inefficien-



cies and cost-reducing activities across operators. Note that the sample does not include the largest networks of France, i.e., Paris, Lyon and Marseille, as they are not covered by the survey. Overall, the panel data set covers 49 different urban transport networks over the period 1987-2001. Note finally that we focus only on transport networks where the operator is not public. This rules out the so-called *Regies* where the service is provided by a public entity (this is mostly the case in large cities such as Paris, Lyon and Marseille). We may indeed expect that those cases are less concerned with the principal-agent problem at the heart of our investigation.

We assume that the network operator has both private information about its innate technology (adverse selection) and that its cost-reducing effort is non-observable (moral hazard). Because French local authorities exercise their new powers on transportation policy since the enactment of the 1982 Law only, and since they usually face serious financial difficulties, their limited auditing capacities is recognized among practitioners. A powerful and well-performed audit system needs effort, time and money. French experts on urban transportation blame local authorities for being too lax in assessing operating costs, mainly because of a lack of knowledge of the technology. The number of buses required for a specific network, the costs incurred on each route, the fuel consumption of buses (which is highly dependent on drivers' skills), the drivers' behavior toward customers, the effect of traffic congestion on costs, are all aspects for which operators have much more data and a better understanding than public authorities. This suggests the presence of adverse selection on innate technology in the first place. Given the technical complexity of these issues, it should be even harder for the local authority to assess whether and to what extent operators undertake efforts to provide appropriate and efficient management. Moral hazard issues arise on top of the adverse selection problem. When compounded, those informational asymmetries play a crucial role in the design of contractual arrangements and financial objectives.

Before turning to the description of the contracts, two additional remarks are worth being stressed. First, private information on demand is not a relevant issue in our industry. Local governments are well-informed about the transportation needs of citizens. The number of trips performed over a certain period are easily observed, and the regulator has a very precise idea of how the socio-demographic characteristics of a urban area fluctuate over time. Given the level of demand, the regulator sets the service capacity provided by the operator. Second, we do not address the issue of determining what should be the

good rate-of-return on capital. The rolling stock is owned by the local government in a majority of networks. In this case, the regulator is responsible for renewing the vehicles, as well as guaranteeing a certain level of capital quality.

## 2.2 Regulatory Contracts

Table 1 sheds light on several features of the regulatory contracts, which are worth emphasizing. As already mentioned, two types of regulatory contracts are implemented in the French urban transport industry. Over the period of observation, fixed-price contracts are employed in 55.5% of the cases. Fixed-price regimes are high-powered incentive schemes, while cost-plus regimes do not provide any incentives for cost reduction.

An important characteristic of the industry is related to the evolution of subsidies over time. The volume of service supplied rises over our period of observation. Operating costs are expected to increase proportionally (or less than proportionally if economies of scale are found to be significant). Once having corrected for the increase of input prices over time, it appears that the average subsidies (per unit of supply, i.e., per seat-kilometer) paid to the operators increase in a significant share of networks. Figure 1 illustrates this pattern for a sample of 10 urban areas.

On average, contracts are signed for a period of 5 to 6 years, which allows us to observe in most cases several regulatory arrangements for the same network. Overall, we observe 136 different contracts. We observe the contract from its starting point for 94 cases. In the same network, the regulatory scheme may switch from cost-plus to fixed-price or from fixed-price to cost-plus between two regulatory periods. We thus observe 20 changes of regulatory regimes, most of them (i.e., 17) being switches from cost-plus to fixed-price regimes. These changes occur because the same local authority may be willing to change regulatory rules, or because a new government is elected and changes the established rules. Note however that the arrival of a new government does not imply an early renegotiation of the contract before its term. New local governments are committed to the contracts signed by the former authority. We detect 22 changes of local governments in our database.

Finally, as already suggested, very few changes of operators are observed over our period of observation: Only 2 new operators proposed services between 1987 and 2001.

### 3 Theoretical Model

Our theoretical model takes into account the various features of the French urban transport industry stressed above and adapts the lessons of the contracting literature under imperfect commitment to fit with those empirical features. First, in our regulatory framework, service providers have the choice between either a fixed-price or a cost-plus contract. Second, contracts may evolve over time with increasing subsidies. We will argue below that such patterns arise when subsidies are “renegotiation-proof.” This positive model is then compared to an hypothetical setting where regulators could commit and optimal subsidies remain constant over time.

Consider a local authority (sometimes referred to as the “principal” in the sequel). Generalizing the objective functions used respectively in Baron and Myerson (1982) and Laffont and Tirole (1993), the preferences of this principal are defined as:

$$W = S - (1 + \lambda)t(C) + \alpha U \quad \text{where } \alpha < 1 + \lambda \text{ and } \lambda > 0.$$

The gross surplus generated by the service  $S$  is supposed to be fixed. Implicitly, we consider a setting where the elasticity of demand is very small which seems a reasonable assumption in the case of transportation.<sup>10</sup> The payment offered by the local government to the firm (sometimes referred to as the “agent” in the sequel) depends on whether fixed-price or cost-plus contracts are used. For a fixed-price contract, the principal offers a fixed payment  $t(C) \equiv b$  for any realized cost  $C$ . With a cost-plus contract, the principal reimburses the cost  $C$  incurred by the firm and  $t(C) \equiv C$  for all  $C$ . Raising subsidies from the local government’s general budget with distortionary taxation entails some dead-weight loss that is captured by introducing a cost of public funds  $\lambda > 0$ .<sup>11</sup>

Local public authorities differ in terms of the weights they give to the operator’s profit  $U$  in their objective functions. To have a meaningful trade-off between the dual objectives of extracting the contractor’s information rent and inducing efficient cost-reducing effort, we assume that  $\alpha < 1 + \lambda$  so that, overall, one extra euro left to the firm is socially costly. Various motivations can be found for such modeling of the preferences of local governments. For instance, the parameter  $\alpha$  might capture the firm’s bargaining power

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<sup>10</sup>Oum et al. (1992).

<sup>11</sup>The estimate for developed countries is close to  $\lambda = 0.3$  (Ballard, Shoven, and Whalley, 1985, and Hausman and Poterba, 1987). Gagnepain and Ivaldi (2002) obtain a similar result in their study of the French transportation sector.

at the time of awarding franchises and reflect *ex ante* competition on these markets.<sup>12, 13</sup>

In view of our empirical study, we have to distinguish local governments according to their political inclination, which corresponds to different weights left to the private operator in their objective functions. We assume that  $\alpha = \bar{\alpha}$  (resp.  $\alpha = \underline{\alpha} < \bar{\alpha}$ ) for a rightist (resp. leftist) local government since it is certainly eager to defend (resp. to fight) the private firm's owners.<sup>14</sup>

Turning now to the cost structure, we follow Laffont and Tirole (1993, Chapter 1) and Rogerson (2003) in considering that the observable cost of one unit of the service  $C$  blends together an adverse selection component  $\theta$  related to the innate efficiency of the service and a cost-reducing managerial effort  $e$ . We postulate the following functional form:

$$C = \theta - e.$$

Effort is costly to provide for the firm's management and the corresponding non-monetary disutility function  $\psi(e)$  is increasing and convex ( $\psi' > 0$ ,  $\psi'' > 0$ ) with  $\psi(0) = 0$ . The intrinsic efficiency parameter  $\theta$  is drawn once for all before contracting from the interval  $[\underline{\theta}, \bar{\theta}]$  according to the common knowledge cumulative distribution  $F(\cdot)$  which has an everywhere positive and atomless density  $f(\cdot)$ . Following the screening literature, we assume that the monotone hazard rate property holds,  $\frac{d}{d\theta}(R(\theta)) > 0$  where  $R(\theta) = \frac{F(\theta)}{f(\theta)}$  so that all optimization problems considered below are quasi-concave.<sup>15</sup>

With those notations in hand, we may as well write the firm's profit as:

$$U = t(C) - C - \psi(e)$$

where  $t(C)$  is the payment received from the public authority.

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<sup>12</sup>In this sector, *Ex ante* competition is not so fierce. Indeed, different operators avoid head-to-head competition and generally make tenders for markets in distinct urban areas. The decision  $n^0$  05-D-38 of the French *Conseil de la Concurrence* shows that competition authorities are well-aware of this downstream collusion between potential operators. In more than 60 % of cases, there is indeed only a single bidder. This potential horizontal collusion is captured in ad hoc way in our framework through the parameter  $\alpha$ . The benefit of such ad hoc specification of the intensity of potential downstream competition is to fit real-world practices while it fortunately eases the analysis of the contractual dynamics.

<sup>13</sup>Following the insights of Baron (1989), Laffont (1996) and Faure-Grimaud and Martimort (2003), these preferences might also result from the fight of various political forces within the local public authority.

<sup>14</sup>Laffont (1996) developed related political economy models of regulation relying on such arguments.

<sup>15</sup>It is worth noticing for the sake of our empirical analysis that the same operator could have different realizations of the innate cost parameter on two different markets. This assumption captures the fact that costs of a particular network are to a large extent idiosyncratic.

### 3.1 Full Commitment

In this section, we assume that the local government offers to the operator a long-term contract which covers two contracting periods. The public authority has all bargaining power at the contracting stage when doing so. The principal can commit himself to any pattern of subsidies and cost reimbursement rules over time. Of course, this ability to commit allows to reach the highest possible intertemporal welfare. This gives us an attractive benchmark against which to assess the alternative model under limited commitment and renegotiation. This benchmark is also useful when we move to our empirical analysis and evaluate the costs of renegotiation.

Let  $\delta$  be the discount factor and let us normalize the length of the first-period accounting period with the weight  $\beta = \frac{1}{1+\delta}$ .

Consider first the case of a long-term fixed-price contract. Such a contract entails subsidies  $(b_1, b_2)$  over both periods. With a fixed-price contract, the principal is able to pass onto the firm's management all incentives to save on costs. Let  $e^*$  be the corresponding first-best effort such that  $\psi'(e^*) = 1$ , and denote by  $k = e^* - \psi(e^*)$  its social value.<sup>16</sup> Such a long-term contract yields to the firm the (normalized) intertemporal payoff

$$\beta b_1 + (1 - \beta)b_2 - \theta + k.$$

Instead, with a long term cost-plus contract, the firm's manager exerts no effort and the firm's payoff is zero.<sup>17</sup>

Only the most efficient operators such that  $\theta \leq \theta^*$  choose fixed-price contracts. By incentive compatibility, if any given type prefers a fixed-price contract, it must be that all types which are more efficient does so also. The types space is thus split between two subsets: those efficient operators taking the fixed-price and those inefficient ones taking the cost-plus long-term contracts. The corresponding cut-off  $\theta^*$  corresponds to an operator being just indifferent between the long-term cost-plus and fixed-price contracts:

$$\theta^* = \beta b_1 + (1 - \beta)b_2 + k.$$

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<sup>16</sup>This parameter is by construction related to the firm's internal organization and incentive structure. Any agency costs coming from the separation of ownership and control between the firm's management and shareholders is encapsulated into the  $\psi(\cdot)$  function.

<sup>17</sup>The operator is not responsible for improving the quality of the service since the latter is set by the local authority and focuses on cost-reducing effort only. Quality entails various dimensions of the public transit operations such as the size of the network, the number and size of lines, the number of stops, the frequency of the service, and the age of the rolling stock.

In particular, the most efficient operators such that  $\theta \leq \theta^*$  earns an information rent,  $\theta^* - \theta$ .

**Remark 1** *Note that the operator's choice between taking either a long-term fixed price contract or a cost-plus one reveals information on the operator's type. After this choice becomes publicly known, the public authority can assess whether that type is above the threshold  $\theta^*$  or not. Under full commitment, that information revelation takes place in one stage only and the public authority is not going to use that information to refine his contractual offers in the future.*

**Remark 2** *It is worth stressing also that, although the public authority offers a menu of long-term contracts, the actual choice made by the operator selects only one item within the menu. In view of our empirical study, we only observe the resulting choice made by operators not the negotiation process that leads to this choice. This process is captured, in the pure mechanism design tradition, by having principals offering first menus among which agents self-select.*

Given those remarks, the principal's intertemporal expected welfare under full commitment can be expressed as:

$$W^F(b_1, b_2) = S - (1 + \lambda) \left( (\beta b_1 + (1 - \beta)b_2) F(\beta b_1 + (1 - \beta)b_2 + k) + \int_{\beta b_1 + (1 - \beta)b_2 + k}^{\bar{\theta}} \theta f(\theta) d\theta \right) \\ + \alpha \int_{\underline{\theta}}^{\beta b_1 + (1 - \beta)b_2 + k} (\beta b_1 + (1 - \beta)b_2 + k - \theta) f(\theta) d\theta.$$

The term  $(\beta b_1 + (1 - \beta)b_2) F(\beta b_1 + (1 - \beta)b_2 + k)$  represents the expected subsidy under a long-term fixed-price contract. The term  $\int_{\beta b_1 + (1 - \beta)b_2 + k}^{\bar{\theta}} \theta f(\theta) d\theta$  is meant for the expected payment under a cost-plus contract. Finally, the last term represents the expected information rent which is left only to the most efficient firms under the fixed-price contract.

Optimization of this objective function yields the values of the optimal subsidies under full commitment.

**Proposition 1** *Under full commitment, the optimal fixed-price contract is the twice-repeated version of the static optimal fixed-price contract. It entails a subsidy  $b^F$  which is*

constant over time  $b_1^F = b_2^F = b^F$  and satisfies:

$$k = \left(1 - \frac{\alpha}{1 + \lambda}\right) R(b^F + k). \quad (1)$$

*Only the most efficient firms with types  $\theta \leq \theta^F = b^F + k$  take this long-term fixed-price contract. The least efficient firms with types  $\theta \geq \theta^F = b^F + k$  take a long-term cost-plus contract.*

The result that, under full commitment, the optimal contract is the twice replica of the optimal static contract is by now standard in the dynamic contracting literature.<sup>18</sup> In particular, given that the economic environment is stationary, there is no chance of moving from a cost-plus to a fixed-price contract over time. This explains why we initially focused on the dichotomic choice between either a long-term fixed-price and a long-term cost-plus contract and do not consider dynamic patterns with cost-plus contracts followed by fixed-prices. Such are certainly suboptimal under full commitment although, as we will see, they play a significant role under limited commitment.

The optimal menu of contracts trades off efficiency and rent extraction. Offering a fixed-price with a sufficiently large subsidy to all types would indeed ensure that the operator exerts the first-best effort whatever its innate technology. However, doing so also leaves too much information rent to the operator and this is socially costly. Offering instead a cost-plus contract to all types nullifies this rent while it also destroys any incentives to exert effort.

The intuition behind condition (1) is as follows. Suppose that the principal offers a fixed subsidy  $b$  in both period. By raising this subsidy by  $db$ , the principal makes it sure that with probability  $f(b + k)db$ , the firm with type in the interval  $[b + k, b + k + db]$  will now exert effort  $e^*$  which generates an expected social benefit  $(1 + \lambda)kf(b + k)db$ . On the other hand, raising the subsidy entails a budgetary cost worth  $(1 + \lambda)F(b + k)db$  since even firms with infra-marginal types will enjoy such an increase. This nevertheless also raises the social value of the rent left to the most efficient firms by a quantity  $\alpha F(b + k)db$ . Finally, an optimal subsidy  $b^F$  trades off the expected efficiency gains with the net cost of increasing the firm's rent.  $b^F$  must balance those two effects and solve:

$$(1 + \lambda)kf(b^F + k)db + \alpha F(b^F + k)db = (1 + \lambda)F(b^F + k)db.$$

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<sup>18</sup>Baron and Besanko (1984) and Laffont and Martimort (2002, Chapter 8) for similar results in more general environments.

Simplifying yields (1).

It is straightforward to check that increasing  $k$  or  $\alpha$  increases the optimal subsidy  $b^F$ . Intuitively, when the firm's effort is more socially valuable or when its rent is found more valuable by the public authority, the optimal subsidy under a fixed-price contract should be raised to induce higher powered incentives and command more rent.<sup>19</sup>

## 3.2 Renegotiation

**Overview and modeling choices:** The full commitment assumption used in Section 3.1 turns out to be excessive in view of real-world practices and as explained above. Although the 1993 Law invites local authorities to re-auction the concession for a fixed period of 5 years, these authorities are either reluctant to really implement the law or do not have enough expertise to launch complex calls for tenders. In practice, local authorities consider the requirement of re-auctioning the contract at fixed dates as the opportunity to renegotiate a contract with the incumbent (the so-called "historical operator") instead of really envisioning the possibility to contract with a new operator.

Theoretical studies to date have distinguished between two kinds of paradigms when it comes to model intertemporal contracting under limited commitment. The first concept is that of long-term contracting with contracts which can be renegotiated if parties find it attractive to do so.<sup>20</sup> The second paradigm considers short-term contracting where parties cannot write any binding agreement for future rounds of contracting and only spot contracts for the current period can be enforced.<sup>21</sup> Although contracts in the French transportation sector have a limited duration, the second of these paradigms does not capture the kind of relational contracting that characterizes a long-lived relationship between a local authority and its "historical operator": The first paradigm better fits evidence, although it must be adapted to take into account that, even though a long-term contract cannot be signed in practice, the promise of having a future round of contracting between the public authority and the incumbent is sufficiently credible. In other words, although

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<sup>19</sup>An interesting question is to investigate the welfare loss that the principal incurs by offering just a menu with only two items in a full commitment environment. This question is particularly important for practitioners. Using our estimates of the full commitment solutions, we address that question in a companion paper (Gagnepain, Ivaldi and Martimort, 2009).

<sup>20</sup>Dewatripont (1989), Laffont and Tirole (1993, Chapter 10), Hart and Tirole (1988) and Rey and Salanié (1990) in adverse selection contexts.

<sup>21</sup>Guesnerie, Freixas and Tirole (1985) and Laffont and Tirole (1993, Chapter 9) among others.



no long-term contracts really bind parties together, everything happens as if those parties credibly commit to promises for further rounds of contracting. The renegotiation paradigm can then be replaced by a “re-negotiation” view of contracting that, although technically similar, captures somewhat different real-world practices.

As soon as the local authority suffers from imperfect information on the operator’s type, the selection of a contract within the simple two-item menu at the early contracting stage reveals some information on the firm’s type. The choice of a fixed-price contract is interpreted by the principal as being “good news” since it signals that the firm’s type is below some cut-off. Instead, the choice of cost-plus contracts brings rather “bad news.” In a dynamic environment, information on the cost structure is revealed over time and the principal would like to draft new agreements that incorporated this new knowledge. In particular, an increase over time in the subsidies under fixed-price contracts allows operators that have revealed themselves as being not very efficient earlier on to achieve productivity gains later on. Such increases in subsidies might thus be viewed as *ex post* attractive from the principal’s viewpoint. However, the major lesson of the renegotiation literature is that these *ex post* efficiency gains also come with *ex ante* costs in delaying information revelation so that, overall, renegotiation is costly from the principal’s viewpoint. Some of the most efficient firms may indeed prefer adopting cost-plus contracts earlier on to enjoy the greater subsidies that future fixed-price contracts will bring later on. This important dynamic trade-off and its impact on information revelation are at the core of our model.

**Timing:** To describe more carefully the dynamics of the relationship between the principal and the operator, let us make more explicit the timing of the contracting game that is considered below:

- Date 0: The firm learns its efficiency parameter  $\theta$ .
- Date 0.25: The principal commits to a menu of subsidies  $(b_1, b_2)$  that would be given under a long-term fixed-price contracts.
- Date 0.50: The firm chooses whether to operate under such long-term fixed-price contract or not. The principal updates his beliefs on the firm’s innate cost following that choice.
- Date 1.00: First-period costs are realized and payments are made accordingly.

- Date 1.25: If he wishes so, the principal makes a renegotiated offer corresponding to a new subsidy  $\tilde{b}_2$  under a fixed-price contract that runs for the second period only.
- Date 1.50: The firm chooses whether to accept this new offer or not and chooses his second-period effort accordingly. If the offer is refused, the old contract be it fixed-price or cost-plus is enforced.
- Date 2: Second-period costs are realized and payments are made.

**Equilibrium notion:** An *almost* perfect Bayesian equilibrium (in short equilibrium) of the contractual game consists of the following strategies and beliefs:

- **Principal's strategy:** The principal offers the profile of subsidies if the firm operates under a long-term fixed-price contracts  $(b_1, b_2)$  at date 1, and a renegotiated offer  $\tilde{b}_2$  which might supersede  $b_2$  at date 2. This second-period offer is made after the principal has updated his beliefs over the firm's type parameter following its first-period decision to operate under the subsidies profile  $(b_1, b_2)$  or not.
- **Agent's strategy:** The firm follows a cut-off strategy and accepts to work on a profile of subsidies  $(b_1, b_2)$  if and only if it is sufficiently efficient, i.e.,  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$ . A firm with an intermediary type in the interval  $\Theta_2 = [\theta_1^*, \theta_2^*]$  (where  $\theta_2^* \geq \theta_1^*$ ) refuses this profile in the first period but accepts to work on a fixed-price contract for the second period if the subsidy is renegotiated towards a level  $\tilde{b}_2$  which is large enough. Such a firm moves thus from a cost-plus to a fixed-price contract over time. Finally, a firm being sufficiently inefficient, i.e.,  $\theta \geq \theta_2^*$ , sticks on cost-plus contracts in both periods.

**Remark 3 “Almost” equilibrium and limited updating:** *It is important to stress that the principal takes into account only the updated beliefs that he has at date 0.50 when making a renegotiated offer. This is a slight departure of full rationality to the extent that the principal should have updated beliefs with the more precise information obtained by observing first-period costs under a cost-plus contract. This departure of full rationality justifies the use of the qualifier “almost” for our notion of equilibrium.*

*Suppose instead that the principal was fully rational and would update beliefs for all realizations of that first-period cost. Inefficient firms under a first-period cost-plus contract would certainly not reveal their type in the first-period and, anticipating future renegotiation of the contract, might claim having the worst possible first-period cost  $C_1 = \bar{\theta}$ . This*

strategy increases the firm's information rent for the first period and it also hides valuable information away from a fully rational principal in view of the second-period contracting. If real-world practices were in lines with such strategy, one would observe mass points of observations for cost-plus contracts. This certainly contradicts our data set where no such masses in realized costs under cost-plus contracts are found.

Suppose instead that an inefficient firm was to adopt a more naive first-period behavior and reveal its type not anticipating the principal's latter use of that information. Such fully rational principal would just learn the firm's type  $C_1 = \theta$  by observing and reimbursing the realized first-period cost. Then, for the second period, that principal would recommend to that operator to work at cost  $C_2^* = \theta - e^*$  and would compensate the firm for incurring that first-best effort. This is clearly a naive strategy for the firm because hiding information early on may induce the principal to increase subsidies at the renegotiation stage and the operator can grasp some second-period rent by doing so.

Our modeling strategy of having an “almost” rational principal who updates his beliefs only from the rough information contained in the decision to take or not the fixed-price contracts in the first period avoids those unpalatable dilemmas. It allows our model to keep all the flavor of the dynamic rent-efficiency trade-off familiar from the theoretical literature on renegotiation without rendering the analysis untractable in our context with a continuum of types. It also satisfies our desire of making the theoretical model as close as possible to the existing data set and this certainly requires some concessions on the theory side.

In the sequel, we will focus on profiles of subsidies that come unchanged through the renegotiation process. We thus mimic the earlier theoretical literature on renegotiation and adopt the following definition of a renegotiation-proof long-term contract.

**Definition 1** *A profile  $(b_1, b_2)$  of subsidies is renegotiation-proof if offering  $\tilde{b}_2 = b_2$  is found optimal by the principal at date 1.25.*

The theoretical literature on renegotiation has shown that focusing on renegotiation-proof mechanisms is without loss of generality.<sup>22</sup> The intuition is as follows. Any long-term contract which is renegotiated in the second period of the relationship could be replaced

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<sup>22</sup>Hart and Tirole (1988), Dewatripont (1989), and Laffont and Tirole (1993, Chapter 10). In a model with a discrete number of types for the privately informed agent, Bester and Strausz (2001, 2007) showed

by a long-term contract with a second-period contract equal to this renegotiated offer. This renegotiated offer is not itself superseded by any new offer for the second period because, if it was so, this would contradict the optimality of the renegotiated offer in the first place. Our focus on renegotiation-proof profiles follows the same logic and is without loss of generality. For any given second-period subsidy  $b_2$ , there exists an optimal second period subsidy  $\tilde{b}_2 \geq b_2$  which maximizes the principal's expected payoff for the second period conditionally on what he has learned from seeing or not the first-period acceptance of the profile  $(b_1, b_2)$ , i.e., that the firm's innate cost is below some threshold  $\theta_1^*$ . Of course, this threshold is itself determined by the perspective of having a renegotiated offer  $\tilde{b}_2$  in the second period. By the very principle of optimality, if the profile  $(b_1, \tilde{b}_2)$  had been offered in the first place, there would be no scope for improving the principal's payoff at date 2.

**Remark 4** *The whole theoretical literature on renegotiation focuses on cases where private information is modeled as being drawn from distribution with discrete supports. Working in a model with a continuum of types as we do here is important for two reasons. First, it clarifies the pattern of information revelation, i.e., how types with intermediate efficiency parameters end up adopting fixed-price contracts in the second period and how the corresponding subsidies increase over time. Second, it is also necessary to take into account the significant heterogeneity in the firm's realized costs that comes from our data set. As we show below, a model with a continuum of types provides a nice division of the space of types into three intervals whose respective probabilities (obtained from the equilibrium behavior of cut-off types that define those intervals) can be matched with the empirical distribution of behaviors observed on our data. Models with discrete types could allow a more detailed analysis of the pattern of information revelation<sup>23</sup> and are thus attractive from a theoretical viewpoint. However, such models are not consistent with our data set. As we argued above, mass points in the distribution of realized costs are not found in our data.*

**Renegotiation-proof profiles:** To be accepted, a renegotiated offer  $\tilde{b}_2$  has to increase the firm's information rent with respect to what it would get with the initial contract.

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more generally that there is no loss of generality in looking for the optimal contract in the set of mechanisms having as much options as the set of possible types. A weak version of the Revelation Principle applies but one has to be cautious and take into account that information is gradually revealed over time so that mixed strategies in information revelation are possible.

<sup>23</sup>By means of the branching processes along the lines of Hart and Tirole (1988) for instance.

Otherwise a firm that already chose the profile of fixed-price contracts in the first period would still have the option of keeping the subsidy  $b_2$  for the second period. Any renegotiated offer  $\tilde{b}_2$  must therefore raise subsidies:

$$\tilde{b}_2 \geq b_2. \quad (2)$$

Solving the game backwards, we first consider how the principal updates his beliefs and makes a new offer at the renegotiation stage given the first-period cut-off strategy followed by the firm. Two cases should be distinguished depending on whether the firm has already accepted to work on a profile of fixed-price contracts ( $\theta \leq \theta_1^*$ ) or not ( $\theta \geq \theta_1^*$ ).

**Case 1: Renegotiation following “good news”,  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$ .** Following the first-period acceptance of the profile  $(b_1, b_2)$ , the principal is led to think that the firm is rather efficient. Updated beliefs are easily obtained from Bayes’ rule using the cut-off strategy of the agent. The updated density is  $\frac{f(\theta)}{F(\theta_1^*)}$  for  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$ .

A renegotiated offer  $\tilde{b}_2$  is accepted in the second period when  $\theta \leq \theta_2^*$  where

$$\theta_2^* = \tilde{b}_2 + k. \quad (3)$$

The new renegotiated offer  $\tilde{b}_2$  maximizes the principal’s expected welfare for the second period where expectations are taken with those updated beliefs. We immediately find:

**Lemma 1** *Assume that all types  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$  accept the profile  $(b_1, b_2)$ . A second-period offer  $b_2$  is part of renegotiation-proof profile  $(b_1, b_2)$  following acceptance of that profile when*

$$b_2 \geq b^F. \quad (4)$$

Intuitively, a second-period subsidy can only be renegotiation-proof when it is greater than under full commitment. Starting from the full commitment level, the principal finds it more costly to marginally increase subsidies and the information rent of all inframarginal firms than to enjoy the efficiency gains withdrawn from such an increase for the marginal type and types close-by.

**Case 2: Renegotiation following “bad news”,  $\theta \in \Theta_1^c = [\theta_1^*, \bar{\theta}]$ .** The first-period refusal of the profile  $(b_1, b_2)$  is interpreted by the principal as coming from the least efficient firms. The updated density function is now  $\frac{f(\theta)}{1-F(\theta_1^*)}$  for  $\theta \in \Theta_1^c$ .

A renegotiated offer is accepted by a firm with type  $\theta$  when (2) holds and  $\theta \geq \theta_2^*$  where

$$\theta_2^* = \tilde{b}_2 + k \geq \theta_1^*.$$

**Lemma 2** *Assume that all types  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$  accept the profile  $(b_1, b_2)$ . A second-period offer  $b_2$  is part of a renegotiation-proof profile following first-period refusal of that profile when*

$$kf(b_2 + k) - \left(1 - \frac{\alpha}{1 + \lambda}\right) (F(b_2 + k) - F(\theta_1^*)) \leq 0. \quad (5)$$

Condition (5) expresses the fact that raising the subsidy for those firms which have revealed themselves as being rather inefficient in the first period by refusing the long-term profile  $(b_1, b_2)$  is not an attractive strategy for the principal. The efficiency gains  $(1 + \lambda)kf(b_2 + k)db$  obtained when increasing the subsidy  $b_2$  by an amount  $db$  (so that the marginal type who is indifferent between the cost-plus and the fixed-price contracts moves up) should be less than the net cost of raising the rent of all types that were not under a fixed-price contract before and now find that option attractive. That costs is worth  $(1 + \lambda - \alpha)(F(b_2 + k) - F(\theta_1^*))db$ .

Taken altogether, the constant subsidy profile  $b_1 = b_2 = b^F$  and the cut-off rule  $\theta_1^* = b^F + k$  found under full commitment never satisfy (5). The optimal long-term contract under full commitment and the corresponding pattern of information revelation are not renegotiation-proof. Intuitively, upon learning that the firm is rather inefficient after an initial refusal of subsidies, the principal wants to slightly raise the second-period subsidy to increase efficiency. Clearly, a firm with a type close to (but below)  $\theta_1^* = b^F + k$  refuses the first-period subsidy because it gives little rent. It prefers to take a first-period cost-plus contract and waits for the increase in the second-period subsidy which comes out of the renegotiation.

Turning now to the firm's strategy, the cut-off type  $\theta_1^*$  must be indifferent between choosing the profile  $(b_1, b_2)$  at date 0.5 so that it reveals its type earlier on, and taking a first-period cost-plus contract plus the renegotiated offer  $b_2$  at date 1.5.:

$$\beta b_1 + (1 - \beta)b_2 + k - \theta_1^* = (1 - \beta)(b_2 + k - \theta_1^*) \Leftrightarrow \theta_1^* = b_1 + k. \quad (6)$$

We can summarize the pattern of information revelation as follows:

- Types  $\theta \in \Theta_1 = [\underline{\theta}, \theta_1^*]$  choose the profile  $(b_1, b_2)$ .

- Types  $\theta \in \Theta_2/\Theta_1 = [\theta_1^*, \theta_2^*]$  choose only the subsidy  $b_2$  in the second-period. Those types move thus over time from a cost-plus to a fixed-price contract.
- Types  $\theta \in [\theta_2^*, \bar{\theta}]$  choose cost-plus contracts for both periods.

That pattern summarizes incentive compatibility constraints but also how information is gradually revealed in this dynamic context. For instance, if the cut-off type  $\theta_1^*$  is just indifferent between adopting subsidies in both periods or only at period 2, more efficient types  $\theta \leq \theta_1^*$  certainly prefer taking subsidies earlier on. Those types reveal right away they belong to the interval  $\Theta_1$ . In the second period, new information is revealed as types in  $\Theta_2$  adopt the renegotiated offer.

Inserting (6) into (5) yields the more compact expression of the renegotiation-proofness constraint:

$$-kf(b_2 + k) + \left(1 - \frac{\alpha}{1 + \lambda}\right) (F(b_2 + k) - F(b_1 + k)) \geq 0. \quad (7)$$

As a direct consequence of (7), we also immediately get

**Proposition 2** *Any renegotiation-proof profile  $(b_1, b_2)$  entails subsidies which are strictly increasing over time:*

$$b_1 < b_2.$$

**Optimal renegotiation-proof profiles:** The optimal renegotiation-proof profile of subsidies maximizes the principal's intertemporal welfare subject to the renegotiation-proofness constraints (4) and (7). It turns out that (4) is slack at the optimum, i.e., renegotiation following "good news" is not a concern. Intuitively, to avoid renegotiating a fixed-price contract that has been refused, the principal is forced to commit to a subsidy above the full commitment outcome. Such subsidy is not renegotiated either if the firm accepts it already in the first period.

Denoting by  $\mu$  the non-negative multiplier of (7), assuming that the corresponding Lagrangean is concave, and optimizing yields the following characterization of the optimal renegotiation-proof contract.

**Proposition 3** *The optimal renegotiation-proof profile  $(b_1^R, b_2^R)$  entails a pattern of strictly increasing subsidies such that:*

$$b_1^R < b_2^R \text{ with } b_1^R < b^F \quad (8)$$

where

$$k - \frac{\mu}{\beta(1+\lambda)} \left(1 - \frac{\alpha}{1+\lambda}\right) = \left(1 - \frac{\alpha}{1+\lambda}\right) R(b_1^R + k); \quad (9)$$

$$k + \frac{\mu}{(1-\beta)(1+\lambda)} \left(1 - \frac{\alpha}{1+\lambda}\right) - \frac{\mu k}{(1-\beta)(1+\lambda)} \frac{f'(b_2^R + k)}{f(b_2^R + k)} = \left(1 - \frac{\alpha}{1+\lambda}\right) R(b_2^R + k); \quad (10)$$

and

$$-kf(b_2^R + k) + \left(1 - \frac{\alpha}{1+\lambda}\right) (F(b_2^R + k) - F(b_1^R + k)) = 0. \quad (11)$$

These equations form the structural system that we will then estimate in our empirical study.

## 4 Empirical Model

Section 4.1 presents our data and the different variables that enter the estimation procedure. This procedure is presented in Section 4.2. Results follow in Section 4.3.

### 4.1 Data

We discuss first the construction of the different variables which enter the estimation procedure. Second, we explain how we organize our dataset for the estimation. In particular, we define precisely what a contractual period is, and which networks are selected under each contractual scenario.

**Construction of the variables:** Table 2 presents statistics on the different variables available in our data set. To understand how contracts are designed by public authorities and how operators choose those contracts, we gather observations on subsidies and operating costs. Costs are not directly used as an estimation device but are useful when putting the estimated inefficiency of the operators into perspective and deriving the effort levels. Information on subsidies is required to recover the distribution of the efficiency parameter. Total costs include wages and charges related to fuel consumption. Subsidies entail all payments to the operator, either at the beginning of the production process which are needed to reimburse expected costs (in the case of fixed-price regimes), as



well as payments to the operator at the end of the contracting period to guarantee full reimbursement of total operating costs (in the case of cost-plus regimes).

Recall that our theoretical model makes the accounting simplification that commercial revenues are kept by the public authority and that costs are reimbursed to the operator. In our data, however, observed subsidies are the differences between expected or final costs and commercial revenues. To make our data coincide with the model, we add commercial revenues to the observed subsidy. Finally, we distinguish between nominal and real terms. Costs and subsidies are deflated using consumer price indexes (all items) for France. Only real costs and subsidies are used during the estimation process.

Operators' characteristics include the size of the network, the number of lines operated, the size of the rolling stock, the share of the labor bill in total costs, the share of drivers in the total labor force, and the identity of the industrial group owning the operator. We thus assume that some firms are more likely to perform efficiently than others due to intrinsic advantages of larger stakes, size, managerial practices and concentration of skills.

The size of the network is the total length of the network measured in kilometers. The number of lines operated in each network as well as the total size of the rolling stock measured in the number of vehicles are also constructed. The share of the wage bill in total costs is computed by dividing the wage bill by total costs. The total labor force includes bus drivers as well as engineers who are keys to improve the operator's productivity. The share of engineers is simply obtained by dividing the number of engineers in each network by the total labor force. Finally, the four important corporations who might own the local operator are Keolis, Transdev, Agir, and Connex. We construct a dummy variable for each of these corporations.

Institutional variables describing the public authority comprise the number of cities involved in organizing the service, the size of the population of the total urban area where the service is provided, and the political color of the local regulator. As explained at the beginning of our text, the urban network may include several municipalities. We observe the number of cities that form each urban area as well as the total population of these areas. We also construct a dummy variable that takes value one if the local government is right-wing, and zero when it is left-wing. Data on the political color of the local government are published by the French national newspaper *Le Figaro*. Note

that, over the period of investigation, local governments may belong to one of the main political groups, ranked according to their position on the political line from extreme right to extreme left (Extreme Right, Right, Center Right, Left, and Extreme Left).<sup>24</sup>

**Definition of a contractual period and network selection:** Our raw data set includes 49 networks observed over the 1987-2001 period. This corresponds to 138 contracts. As a contractual period lasts on average for 5 years, we typically observe series of 3 contracts per network over 1987-2001. Very few cases entail networks where 1, 2, or 4 contracts are observed.

The selection of the relevant sample required for the estimation depends on the nature of the contractual arrangement that is considered:<sup>25</sup>

**Full commitment:** Contractual arrangements entail series of contracts which are, in principle, identical as shown in our theoretical study. When evaluating the distribution of  $\theta$ , we consider all the contracts of our data set (results in Table 3). To estimate Proposition 1, we consider only the 80 fixed-price contracts of our sample (results in Table 4).

**Renegotiation-proof:** We restrict our attention here to networks where a newly elected principal contracts for two periods with an operator. This results in a first sample of 66 contracts that is used to compute the distribution of  $\theta$  (results in Table 5). Then, to estimate the parameters of interest in Proposition 3, we restrict this last sample to series of fixed-price contracts only. This yields a final sample of 26 contracts (results in Table 6).

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<sup>24</sup>A public authority (principal) has its members coming from municipal councils, who are elected by direct universal suffrage for a renewable six-year term. The mayor is elected by the municipal council.

<sup>25</sup>Note that one contract in one network should in principle correspond to a unique observation in our theoretical model, i.e., the contract items should remain constant over the - say - 5 years of a contract period. The data reality may be slightly different. In practice, the data set shows that over a single contract period, many items may be affected by small fluctuations. This may for instance be the case of the operator's supply measured by the number of seat-kilometers available, which, in turns, makes the costs and subsidy levels fluctuate too. These fluctuations follow from exogenous shocks that may affect the activity of the operator over the contract length and are assumed to be iid in our model: changes in traffic conditions, changes in network configuration, road constructions which may cut a service route over a certain period, strikes are all such examples. The economic responses to these predictable shocks are written in the contract. Hence, although the contract items may fluctuate over the contract period, they constitute the objectives of the same contract. Instead of calculating a simple average value of each item over the contractual period when fluctuations are present, we choose to treat each different fluctuation as a separate observation so that the number of degrees of freedom of our study is increased.

## 4.2 Full versus Limited Commitment

We have suggested above that the French urban transportation industry shows several features making it a good candidate for illustrating renegotiation-proof profiles of subsidies. In particular, subsidies increase over time. The renegotiation-proof scenario is our positive representation of reality while full commitment is our hypothetical scenario that will be tested against our positive model.

A renegotiation-proof scenario corresponds to the following possibilities.

- A series of two fixed-price contracts over two contracting periods denoted by  $(FF)$ . From the theoretical model, the operator is then rather efficient ( $\theta \leq \theta_1^*$ ).
- A cost-plus contract followed by a fixed-price contracts ( $CF$  herein). The operator is then only mildly efficient ( $\theta_1^* \leq \theta \leq \theta_2^*$ ).
- A series of two cost-plus contracts ( $CC$  herein). The operator is then rather inefficient ( $\theta \geq \theta_2^*$ ).

A full-commitment scenario corresponds instead to the following possibilities.

- A series  $(F)$  of fixed-price contracts when the operator is rather efficient ( $\theta \leq \theta_F$ ).
- A series  $(C)$  of cost-plus contracts when the operator is rather inefficient ( $\theta \geq \theta_F$ ).

**Full commitment.** We start with the hypothetical and simpler case of full commitment. This corresponds to the subsidy  $b^F$  defined in equation (1). The parameters  $k$ ,  $\alpha$ , and  $\lambda$  are unknown to the econometrician and need to be estimated, while  $b^F$  is observed only when a fixed-price contract is taken. For the purpose of the estimation, we rewrite this equation as follows:

$$k_i = \left(1 - \frac{\alpha_i}{1 + \lambda}\right) R(b_i^F + k_i), \quad i = 1, \dots, N, \quad (12)$$

where  $i$  denotes network  $i$ , and  $N$  is the total number of networks in the sample.

The social value of effort  $k$ , as well as the weight  $\alpha$ , are allowed to vary across networks. These parameters might depend on a set of explanatory variables  $X_i$  which account for the

characteristics of the operator, and a set of explanatory variables  $Z_i$  which characterize the local authority:

$$k_i = k(X_i, \omega), \quad (13)$$

and

$$\alpha_i = \alpha(Z_i, \gamma), \quad (14)$$

where  $\omega$  and  $\gamma$  are two vectors of parameters to be estimated.

These explanatory variables will be discussed in more details when the results of the estimation are presented. Note that we cannot identify separately the weight  $\alpha$  on the operator's profit and the cost of public funds  $\lambda$  since only the ratio  $\frac{\alpha}{1+\lambda}$  matters in defining the optimal subsidy from (1). We will assume several possible values for  $\lambda$ , which are consistent with the cost of an administration operating in a developed country.<sup>26</sup>

Note that the monotone hazard rate  $R(\cdot)$  in (12) is also a priori unknown to us. It needs to be identified to compute our estimation. Assuming a specific distribution for  $F(\cdot)$ , we can write the probability of observing a fixed-price contract as follows: If an operator does not accept a fixed-price contract, it must be because  $\theta$  is too high. By matching the distribution of  $\theta$  to an empirical probability of accepting a fixed-price contract, we can recover the parameters of that distribution. Assume that the  $\theta$ s are independent draws across networks from the same normal distribution with mean  $\nu_{pc}$  and variance  $\sigma_{pc}$ , the probability of accepting a fixed-price contract is the probability of  $\theta_i$  being less than  $b_i^F + k_i$ , namely:

$$\Pr(\theta_i \leq b_i^F + k_i) = F(b_i^F + k_i, \nu_{pc}, \sigma_{pc}), \quad (15)$$

where  $F(\cdot, \nu_{pc}, \sigma_{pc})$  is the cumulative distribution function for that normal distribution (with density  $f(\cdot, \nu_{pc}, \sigma_{pc})$ ).

We estimate the system made of equations (12) and (15). As these two equations are sequential, we can present their estimation procedure separately for ease of exposition. To first recover the values of  $\nu_{pc}$ ,  $\sigma_{pc}$ , and  $\hat{k}_i$ , we write the likelihood  $L_i(\nu_{pc}, \sigma_{pc})$  of observing a specific contract in network  $i$  at period  $t$  as:

$$L_i(\nu_{pc}, \sigma_{pc}) = F(b_i^F + k_i, \nu_{pc}, \sigma_{pc})^\Gamma (1 - F(b_i^F + k_i, \nu_{pc}, \sigma_{pc}))^{1-\Gamma}, \quad (16)$$

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<sup>26</sup>For instance, Ballard, Shoven and Whalley (1985) provided estimates (namely, 1.17 to 1.56) of the welfare loss due to a one-percent increase in all distortionary tax rates. In the case of Canadian commodity taxes, Campbell (1975) found that this distortion is equal to 1.24. More generally, it seems that the distortion falls in the range of 1.15 to 1.40 in countries with an efficient tax collection system.

where  $\Gamma$  is a dummy that takes value one if the observed contract is a fixed-price, and zero otherwise. Assuming that observations are independent across networks, then the log-likelihood function for our sample is just the sum of all individual log-likelihood functions.

$$L(\nu_{pc}, \sigma_{pc}) = \prod_{i=1}^N L_i(\nu_{pc}, \sigma_{pc}). \quad (17)$$

With the estimates  $\hat{\nu}_{pc}$ ,  $\hat{\sigma}_{pc}$ , and  $\hat{k}_i$  in hands, we can calculate the distribution  $F(\cdot, \hat{\nu}_{pc}, \hat{\sigma}_{pc})$ , as well as the monotone hazard rate  $R(\cdot, \hat{\nu}_{pc}, \hat{\sigma}_{pc})$ . Once this is done, we appraise  $\hat{\alpha}_i$  in (12). Rewriting equation (12) as:

$$G(b_i^F, k_i, \alpha_i, \lambda, \nu_{pc}, \sigma_{pc}, \varepsilon_i) = 0, \quad (18)$$

where  $\varepsilon_i$  is a two-sided error term, we can obtain maximum likelihood estimates  $\hat{\alpha}_i$ .

**Renegotiation-proof contracts.** We turn now to the case of limited commitment. As stated in Proposition 3, the optimal renegotiation-proof profile entails increasing subsidies  $(b_1^R, b_2^R)$  which satisfy the system of equations (9) to (11). Our goal is to estimate these equations together with the distribution of  $\theta$ . In this system, the parameters that are unknown to us and need to be recovered are  $k$ ,  $\alpha$ ,  $\lambda$ ,  $\nu$ ,  $\beta$ , as well as  $\nu_{rp}$  and  $\sigma_{rp}$ , the mean and the standard error respectively of the  $\theta$ 's normal distribution. We observe the two variables  $b_1^R$  and  $b_2^R$ , the first and second period subsidy levels respectively. As under full commitment, those parameters might vary across networks. Hence, we rewrite the system (9) to (11) as:

$$k_i - \frac{\mu_i}{\beta_i(1+\lambda)} \left(1 - \frac{\alpha_i}{1+\lambda}\right) = \left(1 - \frac{\alpha_i}{1+\lambda}\right) R(b_{1,i}^R + k_i), \quad (19)$$

$$k_i + \frac{\mu_i}{(1-\beta_i)(1+\lambda)} \left(1 - \frac{\alpha_i}{1+\lambda}\right) - \frac{\mu_i k_i}{(1-\beta_i)(1+\lambda)} \frac{f'(b_{2,i}^R + k_i)}{f(b_{2,i}^R + k_i)} = \left(1 - \frac{\alpha_i}{1+\lambda}\right) R(b_{2,i}^R + k_i), \quad (20)$$

$$-k_i f(b_{2,i}^R + k_i) + \left(1 - \frac{\alpha_i}{1+\lambda}\right) (F(b_{2,i}^R + k_i) - F(b_{1,i}^R + k_i)) = 0, \quad i = 1, \dots, N. \quad (21)$$

We assume again that the social value of effort  $k$ , as well as the weight  $\alpha$  given by the regulator to the operator's utility, are allowed to vary across networks. We expect these parameters to depend on the same sets of explanatory variables  $X_i$  and  $Z_i$ :

$$k_i = k(X_i, \varphi), \quad (22)$$

and

$$\alpha_i = \alpha(Z_i, \chi), \quad (23)$$

where  $\varphi$  and  $\chi$  are two vectors of parameters to be estimated. As under full commitment, we will assume several possible values for  $\lambda$ .

To estimate the above system, we proceed as follows. First equations (19) and (20) can be solved for  $\mu_i$  and  $\beta_i$

$$\mu_i = \mu(b_{1,i}^R, b_{2,i}^R, k_i, \alpha_i, \lambda, \nu_{rp}, \sigma_{rp}), \quad (24)$$

$$\beta_i = \beta(b_{1,i}^R, b_{2,i}^R, k_i, \alpha_i, \lambda, \nu_{rp}, \sigma_{rp}), \quad (25)$$

while (21) is rewritten as

$$J(b_{1,i}^R, b_{2,i}^R, k_i, \alpha_i, \lambda, \nu_{rp}, \sigma_{rp}, \xi_i) = 0, \quad (26)$$

where  $\xi_i$  is an error term.

The estimates  $\hat{\alpha}_i$  are obtained from (21). Moreover, the estimates  $\hat{\nu}_{rp}$ ,  $\hat{\sigma}_{rp}$  and  $\hat{k}_i$  are derived from the estimation of  $\theta$ 's distribution, which is computed following the same method than under full commitment. First, assuming a specific normal distribution for  $F(\cdot)$  in the monotone hazard rate  $R(\cdot)$ , we can write the probability of observing a specific contractual arrangement over two periods.

To recover the characteristics of the distribution of the  $\theta$ s, we replicate the methodology implemented when assuming full commitment as above. However, three types of contractual arrangements are now used (instead of two previously). If an operator does not accept any fixed-price contract (in any period), it must be because it has too large a  $\theta$ . Likewise, if the operator accepts a fixed-price contract in both periods (resp. second period only), it is efficient enough (resp. mildly efficient). By matching the theoretical probabilities of each of those regimes with their empirical probabilities, we can recover the distribution of  $\theta$ .

The operator accepts a fixed-price contract in both periods when  $\theta_i \leq \theta_1^* = b_{1,i}^R + k_i$  so that the probability of accepting such fixed-price contract is:

$$\Pr(\theta_i \leq b_{1,i}^R + k_i) = F(b_{1,i}^R + k_i, \nu_{rp}, \sigma_{rp}), \quad (27)$$

where  $F(\cdot, \nu_{rp}, \sigma_{rp})$  is the cumulative distribution function with density  $f(\cdot, \nu_{rp}, \sigma_{rp})$ . We assume again that the  $\theta$ s are independent draws from a normal distribution that is common across networks.

The operator goes from a cost-plus to a fixed-price contract when  $\theta_1^* \leq \theta_i \leq \theta_2^* = b_{2,i}^R + k_i$ . The probability of such pattern is thus the probability of  $\theta$  being greater than  $b_{1,i}^R + k_i$  and less than  $b_{2,i}^R + k_i$ :

$$\Pr(b_{1,i}^R + k_i \leq \theta_i \leq b_{2,i}^R + k_i) = F(b_{2,i}^R + k_i, \nu_{rp}, \sigma_{rp}) - F(b_{1,i}^R + k_i, \nu_{rp}, \sigma_{rp}). \quad (28)$$

Finally, the operator takes cost-plus contracts in both periods when  $\theta_2^* = b_{2,i}^R + k_i \leq \theta_i$ . The probability of accepting such arrangement is thus:

$$\Pr(b_{2,i}^R + k_i \leq \theta_i) = 1 - F(b_{2,i}^R + k_i, \nu_{rp}, \sigma_{rp}). \quad (29)$$

The likelihood of observing one specific contractual arrangement in network  $i$  over period  $t$  can thus be written as:

$$L_i(\nu_{rp}, \sigma_{rp}) = F(b_{1,i}^R + k_i, \nu_{rp}, \sigma_{rp})^\Delta (F(b_{2,i}^R + k_i, \nu_{rp}, \sigma_{rp}) - F(b_{1,i}^R + k_i, \nu_{rp}, \sigma_{rp}))^\Pi (1 - F(b_{2,i}^R + k_i, \nu_{rp}, \sigma_{rp}))^\Sigma, \quad (30)$$

where  $\{\Delta, \Pi, \Sigma\}$  are three dummies taking value one if the observed contractual arrangement is of type  $\{FF, CF, CC\}$  respectively, and zero otherwise.

Since observations are independent, the likelihood function for our sample is just the product of all individual log-likelihood functions:

$$L(\mu_{rp}, \sigma_{rp}) = \prod_{i=1}^N L_i(\nu_{rp}, \sigma_{rp}).$$

Once estimates  $\hat{\nu}_{rp}$ ,  $\hat{\sigma}_{rp}$ , and  $\hat{k}_i$  are obtained,  $\hat{\alpha}_i$  is derived from (26), and  $\hat{\mu}_i$  and  $\hat{\beta}_i$  are evaluated from (24) and (25).

### 4.3 Estimation Results

We now present the results of our estimation for both regulatory scenarios: the hypothetical case of full commitment, and the renegotiation-proof profile which we believe fits the French urban transport industry better. In both cases, results are presented in two steps: First, we discuss the set of results associated to the estimation of  $\theta$ 's distribution,  $F(\cdot)$ . This sheds light on which factors affect significantly the social value of effort  $k$ . In a second step, we focus on the regulatory arrangements induced by Propositions 1 and 3, and discuss our results on the estimated weight  $\alpha$  on the firm's profit in the authority's

objective, the intertemporal weight  $\beta$  from one contractual period to another, and the multiplier  $\mu$  of the renegotiation-proofness constraint.

**Full commitment:** To estimate  $F(\cdot)$ , we need to determine which variables  $X$  affect the social value of effort  $k$ . Explanatory variables are related to the characteristics of the operator, i.e., its skills and managerial ability, as well as its effort technology. These variables are a constant, a trend, the total size of the service network in kilometers, the number of lines operated, the size of the rolling stock in number of vehicles, the share of the labor bill in total costs, the percentage of engineers in the total labor force, a dummy variable that takes value 1 if the operator belongs to the corporation Keolis and 0 otherwise, a dummy variable that takes value 1 if the operator belongs to the corporation Agir and 0 otherwise, and a dummy variable that takes value 1 if the operator belongs to the corporation Connex and 0 otherwise.

Results are presented in Table 3. In the course of the estimation, we realized that the patterns which explain the social value of effort highly differ from one network to another, i.e., we could not obtain unique significant effects for all operators. Hence, we allow estimation results to vary from one group to another. We present three different estimations.

In (I),  $k$  depends on four dummy variables which account for the identity of the group the operator belongs to (Connex is the reference group). Only Transdev has a significant and positive effect on  $k$ , suggesting that an operator belonging to Transdev seems to guarantee a higher social return on managerial effort compared to operators from any other group.<sup>27</sup>

In (II), the explanatory variables are a constant for each group and the size of the network interacted with each one of the group dummy variables. The results show that the size of the network significantly and positively affects the social value of effort in networks where Agir and Transdev operate. This is probably an illustration of the fact that economies of scale in effort technology are greater for larger networks.

In (III), the explanatory variables are a constant for each group and the share of engineers interacted with each one of the group dummy variables. The share of engineers

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<sup>27</sup>The social value of effort is inversely related to the technological cost of effort, which implies that Transdev also enjoys a less costly effort technology. It would be interesting to relate these findings to the internal structure of managerial incentives within the operator but we did not have access to any related information.



provides a measure for the endowment of skills embodied in the firm. Engineers are generally responsible for research and development, quality control, maintenance, and efficiency. Their action is particularly important to improve the average speed of the network. We expect thus the share of engineers in the total labor force to positively affect the social value of effort. Instead, the results suggest ambiguous effects. If the operator belongs to Transdev, the share of engineers has the expected effect. If the operator belongs to Agir, the effect goes in the opposite direction.

Other variables such as the number of lines operated, the size of the rolling stock, or the share of the labor bill in total costs have not provided significant results. The four estimation procedures yield very similar estimates of  $\nu_{pc}$  and  $\sigma_{pc}$ , the mean and standard deviation of  $\theta$ 's normal distribution respectively. Our results are strongly significant, and suggest that the average innate cost  $\theta$  is close to 22 millions Euros. By comparing this value to the average (real) operating costs given in Table 1, we get an average effort level of around 5 millions Euros for the whole industry, which represents a 23% reduction of the initial adverse selection parameter  $\theta$ . This shows that managerial effort is of significant value for that industry.

Once we have estimated  $\nu_{pc}$ ,  $\sigma_{pc}$ , and  $\hat{k}_i$ , we evaluate  $\hat{\alpha}_i$ , the weight of the operator's profit in the public authority's objective function. The explanatory variables which enter  $Z_i$  are a constant, the number of cities that form the local authority in charge of the organization of the service, the size of the population of the relevant urban area, and the political color of the local regulator. With the first two variables, we want to test whether the size of the city or a greater division of the network into distinct urban areas affects the bargaining power of the operator. We expect the latter to be more important in small networks or networks made of many urban areas. With respect to the political color of the local government, casual evidence suggests that a right-wing local government is more eager to provide favors to private operators.  $\hat{\alpha}_i$  should thus be higher with a right-wing local government.

Results are presented in Table 4. The estimation of the average  $\alpha$  are made under the assumption that the local cost of public funds takes values  $\lambda = \{0.1, 0.2, 0.3, 0.4\}$  respectively. Several comments are worth being made. First, the number of cities that constitute the local authority and the size of the population were not significant and have been discarded. Second, whether the government is right-wing or not has a positive and

very significant impact on  $\alpha$ , confirming thereby our prior intuition. Third,  $\alpha$  increases with  $\lambda$  but our initial restriction  $\alpha \leq 1 + \lambda$  holds always, even though it is not imposed in the estimation.

**Limited commitment.** The estimation procedure is similar to the full commitment case.

First, we need to estimate the distribution of  $\theta$ ,  $F(\cdot)$ . Explanatory variables for  $k$  are the same as before. Three different estimations are also considered here, depending on which group of explanatory variables is used: (I) Four dummy variables denoting the identity of each group, (II) a constant plus the effect of the network size for each group, and (III) a constant plus the share of engineers for each group.<sup>28</sup>

The results are presented in Table 4. With respect to the estimation of  $k$ , several comments are in order. First, as far as only dummy variables are concerned, Transdev is the group with the highest social value of effort. In (II), the different groups seem to react differently to an increase in the size of the network. In (III), they also react differently to an increase in the share of engineers.<sup>29</sup>

Again, the three estimations yield very similar estimates of  $\nu_{rp}$  and  $\sigma_{rp}$ , the mean and standard deviation of  $\theta$ 's. Our results are strongly significant and suggest that the average  $\theta$  is close to 20 millions Euros whereas the average level of effort for the whole industry lies around 3 millions Euros. Cost-reducing activities represent thus a 15% reduction of the initial adverse selection parameter  $\theta$ . Thus, the renegotiation-proof scenario implies more efficient operators exerting lower levels of effort on average.

With the estimated  $\hat{\nu}_{rp}$ ,  $\hat{\sigma}_{rp}$ , and  $\hat{k}_i$  in hands, we turn to the evaluation of  $\hat{\alpha}_i$ ,  $\hat{\beta}_i$  and  $\hat{\mu}_i$ . Average values of these parameters are presented in Table 5. Again, we perform these estimations assuming that the local cost of public funds takes values  $\lambda = \{0.1, 0.2, 0.3, 0.4\}$ . Whether the government is right-wing or not has a positive and very significant impact on  $\alpha$ , but the estimated parameter in this case is much lower than  $1 + \lambda$ . More generally, and comparing estimates of  $\alpha$  across regimes, we observe that those estimates are systematically higher under full commitment than under a renegotiation-proof scenario.

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<sup>28</sup>The reader might remember that a major difference is that now three regulatory arrangements are considered instead of two as under full commitment.

<sup>29</sup>Note that the effects go sometimes in an opposite direction than the ones obtained in the full commitment case.

Second, the average intertemporal weight  $\beta$  is equal to 0.53, suggesting that both first and second periods are perceived as equally important in the contractual arrangement. Finally, the average multiplier ranges from 0.14 to 0.18.

The explanation for the difference in estimates between the full commitment and the renegotiation-proof scenarios is easily understood when coming back on the renegotiation-proofness constraint (7). Remember first that renegotiation is more of a concern when the parameter  $1 - \frac{\alpha}{1+\lambda}$  is greater, i.e., when the net social cost of the operator's rent is small enough so that the efficiency gains from renegotiation outweigh the costs of giving up extra information rents. By the same token, renegotiation is also more of a concern when efficiency gains are high, i.e., when  $k$  is greater. Considering a renegotiation-proof scenario amounts thus to “choose” a higher value of this parameter. Looking at (7), a higher estimate of  $k$  under a renegotiation-proof scenario than under full commitment comes also with a higher estimate of  $1 - \frac{\alpha}{1+\lambda}$ , i.e., a lower weight on the firm's profit in the renegotiation-proof scenario.

Our estimation results in Tables 2 and 4 go in the expected directions. First, note that  $\alpha$  is greater in the full commitment case than in the renegotiation-proof one. Second,  $k$  is greater under renegotiation-proof than under full commitment. Estimated  $\hat{\omega}$  and  $\hat{\varphi}$  allow us to compute average  $\hat{k}$  under both situations. Full commitment entails average values of  $\hat{k}$  equal to 0.13 (I), 0.18 (II), and 0.14 (III), while renegotiation-proofness entails values equal to 0.17 (I), 0.51 (II), and 1.04 (III).

Lastly, as it can be seen from the right-hand side of the renegotiation-proofness constraint (7), renegotiation is more costly when increasing subsidies over time significantly shifts rents towards the operator which arises when types are “on average” rather efficient. Neglecting that constraint biases the types distribution towards considering operators with higher costs, which is confirmed by our estimations.

## 5 The Welfare Gains of Commitment

We assess now the magnitude of the welfare gains which can be obtained once one moves from the renegotiation-proof setting to the less constrained full commitment scenario. We also evaluate how these gains are distributed between private operators and taxpayers. This is an important issue for practitioners since they have often complained on the

insufficient length of concession contracts in this sector.

Starting from our estimates of the various parameters of the model obtained from the estimation of the renegotiation-proof scenario, we can reconstruct estimates of the average social cost of subsidies and the average rent left to operators under both scenarios.<sup>30</sup> We proceed as follows.<sup>31</sup>

- **Step 1.** Using our set of renegotiation-proof estimates  $\Upsilon^R = (\hat{\nu}^R, \hat{\sigma}^R, \hat{k}^R, \hat{\alpha}^R, \hat{\beta}^R)$  conditional on  $\lambda$  and its expression from the maximand in renegotiation-proof program  $\mathcal{P}^R$ , we compute expected welfare levels  $W_i^R$  for each network of our data set. As emphasized throughout this section, the renegotiation-proof arrangements correspond to the actual contractual practices implemented in the French urban transport industry. Hence, the estimates  $\Upsilon^R$  provide the econometrician with some information on the true characteristics of the operator and the public authority.

- **Step 2.** We simulate the hypothetical subsidy level  $\hat{b}_i^F$  that would be paid under full commitment. To do so, we solve (1) with respect to  $\hat{b}_i^F$ , using the real networks characteristics  $\Upsilon^R$ .

- **Step 3.** We reconstruct the hypothetical welfare measures  $\hat{W}_i^F$  for each network of our data set, as predicted by our full commitment solution, and using our estimates  $\hat{b}_i^F$  and  $\Upsilon^R$ .

We compute the total welfare gains as well as the gains for taxpayers and operators from commitment by considering an average network of the data set, using estimates  $\Upsilon^R$  conditional on  $\lambda = 0.3$  and  $k_i$  specified as in (II) in Table 5.<sup>32</sup>

The estimates reported in Table 7 shed light on several interesting results. Of course, commitment always improves welfare, compared to the situation where renegotiation puts further constraints on contracting. There is no surprise there, and the important question is not whether one gains by committing but how those gains are distributed. Second, it turns out that  $\hat{b}_i^F > \hat{\beta}_i^R b_{i,1}^R + (1 - \hat{\beta}_i^R) b_{i,2}^R$ , i.e., switching from renegotiation-proof to full commitment entails a higher intertemporal subsidy. In fact, the intertemporal payment

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<sup>30</sup>Remember that our theoretical model has normalized the value of the service at some fixed level  $S$  so that consumers' gross surplus does not change when considering different regimes. This variable will thus be omitted in our analysis.

<sup>31</sup>See the Appendix for details.

<sup>32</sup>Note that the final welfare results do not vary in a significant manner if other values of  $\lambda$  or  $k_i$  are chosen.

to the operator increases, on average, by 27.3 %. Hence, taxpayers lose from an increase in the commitment period of concession contracts, even though it is not a major loss in expected terms as suggested by the small increase in tax burden (+3.8%).

Turning now to operators, our estimates show that their intertemporal rent increases when moving to full commitment by 12,2%: This is a significant gain that explains why operators are so eager to extend the length of the concession contract in this sector.

## 6 Conclusion

We have developed a principal-agent model under limited commitment that features the main characteristics of contracts and institutional practices in the French urban transportation sector. On top of estimating key parameters of the economic and political landscape in this sector, this model has allowed us to evaluate the cost of renegotiation and how welfare gains would be redistributed by increasing contract duration and improving commitment.

In this conclusion, we would like to make a few remarks and suggest a few alleys for further investigation. First, we have deliberately restrained the general feature of theoretical models of limited commitment in order to be able to bring the lessons of those models to the data. Computing the optimal renegotiation-proof contract with a continuum of types (already a first-magnitude theoretical challenge) in the perspective of estimating it econometrically would be a very messy and painful project. Taking data and institutional constraints seriously forced us instead to focus on the case of simple two-item menus which, although suboptimal, allows us to bring the extra benefits of tractability when it comes to a dynamic analysis. This “applied theory” procedure seems to us extremely promising in areas like dynamic contract theory where “pure theory” is either producing untractable models or would make progresses at the cost of imposing heroic assumptions on the underlying type distribution (assuming typically discrete types), assumptions that would be hardly corroborated by data. Our approach could certainly be fruitful also for other industries and contractual environments.

Second, even though our estimates show that welfare gains of commitment are significant, we are certainly underestimating these gains here. Indeed, we have no ideas on how renegotiation weakens the operator’s incentives to make any relationship-specific

investment in this sector except through informal talks with practitioners in the field. Introducing those considerations would even further push for an increase in contract length that could secure investments and avoid hold-up effects.

Third, a more complete analysis of the renegotiation process should incorporate the possibility that public authorities build reputations for being tough on renegotiation. Indeed, such reputation would be beneficial in relaxing renegotiation-proofness constraints. In other words, an omitted variable of our analysis is the amount of reputational capital available to the contracting parties. That capital may be much easier to build in political contexts where public authorities are likely to be reelected in the future and still in charge with regulating the service in later periods. Our theoretical model has put aside those reputation issues and has thus analyzed a “worst scenario” under renegotiation. More research both on the theory side and also in building data sets which could account for that reputational capital is certainly called for.

Fourth, our estimation has highlighted a few systematic differences between operators of different companies in their abilities to generate social value through managerial efforts. It would be worth linking those different abilities to the internal organizations, the management practices and incentive structures of those firms. But again, we have no information on this issue at this stage.

Lastly, our estimate of the cost distribution allows us to ascertain whether the restriction to simple menus is relevant or not even in the static context. Echoing the theoretical works of Rogerson (2003) and Chu and Sappington (2007), we could now ask whether the simple two-item menu fares well compared with more complete menus of contracts given the estimated distributions. In this respect, our conjecture based on casual investigations with practitioners is that, yes, simple menus perform well and the gains from more complex design within each period is unlikely of being of the same magnitude as the welfare gains from improved commitment. Overall, our conjecture is that major sources of contractual benefits come more from better institutional design than from more complex contractual engineering.

We hope to investigate some of those issues in future research.

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## Appendix

• **Proof of Proposition 1:** Under full commitment, the principal’s problem can be rewritten as:

$$(\mathcal{P}^F) : \max_{(b_1, b_2)} W^F(b_1, b_2)$$

The monotone hazard rate property ensures quasi-concavity of this objective.<sup>33</sup> The corresponding first-order conditions yield finally the characterization of the optimal subsidy in (1). ■

• **Proof of Lemma 1:** The optimal subsidy  $\hat{b}_2$  should thus solve the following problem at the renegotiation stage:

$$(\mathcal{P}_2^R) : \max_{\tilde{b}_2} W_{2G}(\tilde{b}_2) \text{ subject to (2).}$$

where the second-period welfare following “good news” is given by

$$W_{2G}(\tilde{b}_2) = S - (1 + \lambda) \left( \tilde{b}_2 \frac{F(\tilde{b}_2 + k)}{F(\theta_1^*)} + \int_{\tilde{b}_2 + k}^{\theta_1^*} \frac{\theta f(\theta)}{F(\theta_1^*)} d\theta \right) + \alpha \int_{\underline{\theta}}^{\tilde{b}_2 + k} \frac{\tilde{b}_2 + k - \theta}{F(\theta_1^*)} f(\theta) d\theta$$

Differentiating the above maximand with respect to  $\tilde{b}_2$  yields

$$W'_{2G}(\tilde{b}_2) = (1 + \lambda)kf(\tilde{b}_2 + k) - (1 + \lambda - \alpha)F(\tilde{b}_2 + k).$$

The maximum of the principal’s expected welfare is thus achieved for  $\hat{b}_2 = b_2$  as requested by the renegotiation-proofness constraint (2) when  $b_2 \geq b^F$ . ■

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<sup>33</sup>See for instance Bagnoli and Bergstrom (2005).

• **Proof of Lemma 2:** The optimal subsidy  $\hat{b}_2$  that can be offered at the renegotiation stage solves now the principal's second period welfare when evaluated with the updated beliefs following “bad news” (i.e., the decision to stick to a cost-plus contract in the first period):

$$(\mathcal{P}_2^R) : \quad \max_{\tilde{b}_2} W_{2B}(\tilde{b}_2) \text{ subject to (2)}$$

where

$$W_{2B}(\tilde{b}_2) = S - (1 + \lambda) \left( \tilde{b}_2 \frac{(F(\tilde{b}_2 + k) - F(\theta_1^*))}{1 - F(\theta_1^*)} + \int_{\tilde{b}_2 + k}^{\bar{\theta}} \frac{\theta f(\theta) d\theta}{1 - F(\theta_1^*)} \right) + \alpha \int_{\theta_1^*}^{\tilde{b}_2 + k} (\tilde{b}_2 + k - \theta) \frac{f(\theta) d\theta}{1 - F(\theta_1^*)}.$$

Differentiating the above maximand with respect to  $\tilde{b}_2$  yields

$$W'_{2B}(\tilde{b}_2) = (1 + \lambda)kf(\tilde{b}_2 + k) - (1 + \lambda - \alpha)(F(\tilde{b}_2 + k) - F(\theta_1^*)).$$

The maximum of the principal's expected welfare is thus achieved for  $\hat{b}_2 = b_2$  as requested by the renegotiation-proofness constraint (2) when (5) holds. ■

• **Proof of Proposition 2:** Since  $\alpha < 1 + \lambda$  and the density function is positive, (7) implies:  $F(b_2 + k) - F(b_1 + k) > 0$ , i.e.,  $b_1 < b_2$ . ■

• **Proof of Proposition 3:** The optimal renegotiation-proof subsidies maximize the principal's intertemporal welfare subject to the renegotiation-proofness constraints (4) and (7).

$$(\mathcal{P}^R) : \quad \max_{(b_1, b_2)} W^R(b_1, b_2) \text{ subject to (4) and (7)}$$

where

$$\begin{aligned} W^R(b_1, b_2) = & S - (1 + \lambda)(\beta b_1 F(b_1 + k) + (1 - \beta)b_2 F(b_2 + k)) \\ & - (1 + \lambda) \left( \beta \int_{b_1 + k}^{\bar{\theta}} \theta f(\theta) d\theta + (1 - \beta) \int_{b_2 + k}^{\bar{\theta}} \theta f(\theta) d\theta \right) \\ & + \alpha \left( \beta \int_{\underline{\theta}}^{b_1 + k} (b_1 + k - \theta) f(\theta) d\theta + (1 - \beta) \int_{\underline{\theta}}^{b_2 + k} (b_2 + k - \theta) f(\theta) d\theta \right). \end{aligned}$$

Because  $\mu > 0$ ,  $\alpha < 1 + \lambda$  and  $R(\cdot)$  is increasing, (9) immediately implies that  $b_1^R < b^F$ . Proposition 2 implies then  $b_1^R < b_2^R$ . ■

• **Welfare Estimates:** Using our estimates from the case where renegotiation-proof contracts are considered, we get the following expression of welfare in network  $i$ :

$$W_i^R = S - T_i^R + \hat{\alpha}_i^R U_i^R, \quad (31)$$

where

$$T_i^R = (1 + \lambda)(\widehat{\beta}_i^R b_{i,1}^R F(b_{i,1}^R + \widehat{k}_i^R) + (1 - \widehat{\beta}_i^R) b_{i,2}^R F(b_{i,2}^R + \widehat{k}_i^R)) \\ + (1 + \lambda) \left( \widehat{\beta}_i^R \int_{b_{i,1}^R + \widehat{k}_i^R}^{\bar{\theta}} \theta f(\theta) d\theta + (1 - \widehat{\beta}_i^R) \int_{b_{i,2}^R + \widehat{k}_i^R}^{\bar{\theta}} \theta f(\theta) d\theta \right),$$

and

$$U_i^R = \widehat{\beta}_i^R \int_{\underline{\theta}}^{b_{i,1}^R + \widehat{k}_i^R} (b_{i,1}^R + \widehat{k}_i^R - \theta) f(\theta) d\theta + (1 - \widehat{\beta}_i^R) \int_{\underline{\theta}}^{b_{i,2}^R + \widehat{k}_i^R} (b_{i,2}^R + \widehat{k}_i^R - \theta) f(\theta) d\theta.$$

Likewise, from our full commitment program  $(\mathcal{P}^F)$ , we define welfare as the weighted sum of surplus  $S$ , expected taxes  $T_i^F$  and operator's expected rent  $U_i^F$  weighted by the corresponding weight  $\widehat{\alpha}_i^R$ :

$$W_i^F = S - T_i^F + \widehat{\alpha}_i^R U_i^F, \quad (32)$$

where

$$T_i^F = (1 + \lambda) \left( \widehat{b}_i^F F(\widehat{b}_i^F + \widehat{k}_i^R) + \int_{\widehat{b}_i^F + \widehat{k}_i^R}^{\bar{\theta}} \theta f(\theta) d\theta \right),$$

and

$$U_i^F = \int_{\underline{\theta}}^{\widehat{b}_i^F + \widehat{k}_i^R} (\widehat{b}_i^F + \widehat{k}_i^R - \theta) f(\theta) d\theta.$$

Note that the gross surplus  $S$  vanishes at the moment of calculating the difference between both welfare measures  $WC_i^R$  and  $WC_i^F$ . Hence, we evaluate the welfare differential between both renegotiation-proof and perfect commitment situations as

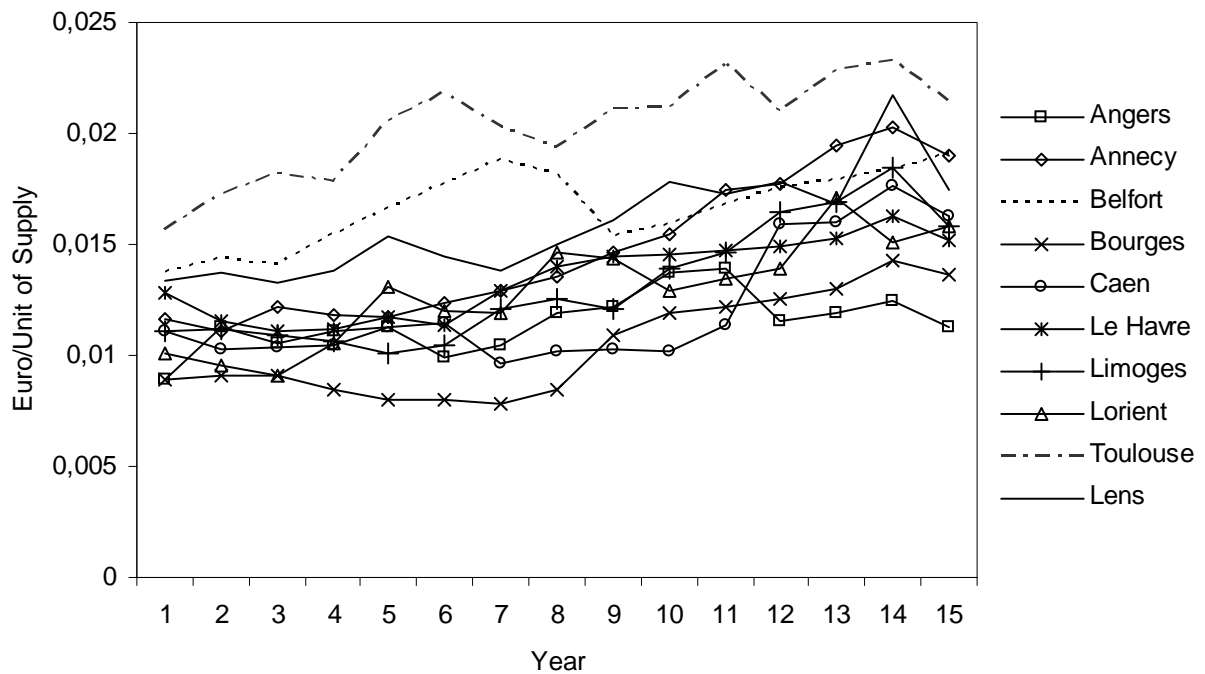
$$\Delta W_i = W_i^F - W_i^R. \quad (33)$$

Similar definitions follow for  $\Delta T_i^F$  and  $\Delta U_i$ . ■

Name	Quantity
Period of observation	1987-2001
Number of networks	49
Changes of operators	2
Changes of local governments	22
Number of contracts	136
Fixed-price contracts	75
New contracts	94
Switch contract type	20
Switch Cost-plus to Fixed-price	17

Table 1: Contracts

Graph 1: Subsidy per Unit of Supply



<b>Variables</b>	<b>Mean</b>	<b>Stand. Dev.</b>
Nominal Cost (Euros)	20,549,568	19,273,852
Nominal Subsidy (Euros)	20,702,141	19,239,199
Including Revenue (Euros)	9,608,629	10,526,903
Subsidy per unit of supply (Euro)	0.016	0.005
Real Costs (Euros)	16,997,693	15,483,483
Real Subsidy (Euros)	18,760,150	17,395,482
Size of the network (km)	288.3	200.1
# of lines	23.6	13.2
# of vehicles	168.1	119.5
# of cities in the urban network	18.3	16.7
Size of population	236,799	177,641
Share of Labor in total costs	0.64	0.10
Share of engineers	0.29	
Share right-wing government	0.52	
Share Fixed Price contracts	0.55	
Share Keolis	0.32	
Share Agir	0.16	
Share Connex	0.22	
Share Transdev	0.24	

Table 2: Data

Variables	Social value of effort $k$		
	I	II	III
Agir	-0.08 (0.07)	-1.31*** (0.46)	-4.42*** (1.22)
Keolis	0.05 (0.06)	-0.09 (0.13)	-0.10 (0.27)
Transdev	0.52*** (0.11)	0.26 (0.18)	2.09*** (0.90)
Agir $\times$ size		5.07*** (1.72)	
Keolis $\times$ size		0.52 (0.39)	
Transdev $\times$ size		1.60** (0.83)	
Agir $\times$ Engineers			-5.99*** (1.65)
Keolis $\times$ Engineers			-0.21 (0.37)
Transdev $\times$ Engineers			2.22*** (1.20)
Mean $\theta$ ( $\times 10000$ )	0.22*** (0.04)	0.23*** 0.06	0.22*** (0.04)
Stand. Dev. $\theta$ ( $\times 10000$ )	0.47*** (0.08)	0.51*** 0.16	0.48*** (0.09)
# of Contracts		138	

Table 3: Full Commitment: Inefficiency distribution and social value of effort

$\lambda$	$\alpha \times \text{right wing}$		
	<b>I</b>	<b>II</b>	<b>III</b>
0.4	1.29*** (0.03)	1.38*** (0.01)	1.37*** (0.01)
0.3	1.19*** (0.03)	1.28*** (0.01)	1.27*** (0.01)
0.2	1.10*** (0.03)	1.18*** (0.02)	1.17*** (0.01)
0.1	1.01*** (0.02)	1.08*** (0.01)	1.07*** (0.01)
# of Contracts		80	

Table 4: Full Commitment: Parameter of interest in Proposition 1



Variables	Social value of effort $k$		
	I	II	III
Agir	0.02 (0.05)	-0.26** (0.12)	-2.19*** (0.73)
Keolis	0.07* (0.04)	0.32*** (0.08)	-0.08 (0.46)
Transdev	0.41*** (0.07)	0.41*** (0.11)	2.04** (0.80)
Agir $\times$ size		1.25** (0.49)	
Keolis $\times$ size		-0.76*** (0.21)	
Transdev $\times$ size		-0.06 (0.34)	
Agir $\times$ Engineers			3.05*** (1.00)
Keolis $\times$ Engineers			0.21 (0.63)
Transdev $\times$ Engineers			-2.27** (1.09)
Mean $\theta$ ( $\times 10000$ )	0.20*** (0.03)	0.20*** (0.03)	0.20*** (0.03)
Stand. Dev. $\theta$ ( $\times 10000$ )	0.22*** (0.02)	0.21*** (0.02)	0.22*** (0.02)
# of Contracts		66	

Table 5: Renegotiation-proof: Inefficiency distribution and social value of effort

Parameter	I					II			
	$\lambda$	0.1	0.2	0.3	0.4	0.1	0.2	0.3	0.4
$\alpha \times \text{right wing}$		0.61*** (0.13)	0.67*** (0.14)	0.73*** (0.14)	0.78*** (0.16)	0.64*** (0.13)	0.70*** (0.14)	0.76*** (0.15)	0.82*** (0.16)
$\beta$		0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)	0.53*** (0.03)
$\mu$		0.14** (0.07)	0.16** (0.07)	0.17** (0.08)	0.18** (0.08)	0.14** (0.07)	0.16** (0.07)	0.17** (0.07)	0.18** (0.08)
$\sigma_\epsilon$		0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)	0.04*** (0.01)
# of Contracts		26							

Table 6: Renegotiation-proof: Parameters of interest in Proposition 2

<b>Welfare Items</b>	<b>Total (in Million Euros)</b>
Subsidy	
- Full commitment (estimated)	21.7
- Renegotiation-proof 1	15.5
- Renegotiation-proof 2	18.9
Differential 1	+6.2
Differential 2	+2.9
Social cost	
- Renegotiation-proof	23.8
- Full commitment	24.7
Differential	+0.9
Rent operator	
- Renegotiation-proof	21.2
- Full commitment	23.8
Differential	+2.6
Total welfare	
- Renegotiation-proof	-0.35
- Full commitment	1.65
Differential	+2.0
# of Contracts	26

Table 7: Welfare differentials for the average network